EXHIBIT J

The ABX index: A pricing conundrum

The liquidity crisis in the ABS market has led to investors using the ABX index as a valuation tool for individual securities – something the index was never designed for. Ben Logan explains the ramifications of this valuation practice

The Markit ABX index has, in its two years of life, evolved from being an arcane index tracking a set of US home equity market derivatives to becoming a widely watched barometer of the health of the ABS markets. The use of the ABX index has also expanded from pure trading tool to primary input for the valuation of cash ABS portfolios.

It is the use of the ABX as a valuation tool that has proved to be contentious. This should not come as a surprise, given the original purpose of the index. It is a basket of 20 credit default swaps referencing US subprime home equity securities. It has allowed investors to go long or short exposure to US subprime residential mortgages, and remains liquid and transparent in these volatile markets.

As one of the few areas of liquidity in today's tumultuous and thinly traded ABS market – and due to the lack of alternative observable prices – many financial institutions have interpreted FAS 157 as requiring them to adopt the ABX as a valuation tool. As a result, cash portfolios have been marked down using an index that represents a relatively small proportion of their diversity. The ABX may be a standardised and liquid tradable index but it was not designed to be uncritically extrapolated to the broader ABS market, and it was certainly not designed as a valuation tool for individual securities.

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Compare the ABX to equity indices. While movements in the Dow Jones Industrial Average, for example, may provide a snapshot of market performance, the index performance will not give an equity investor information on the performance or value of a specific stock. You would not mark Vodafone stock using the Dow Jones, of which it is not even a member, nor would you mark Ford bonds using the Markit CDX IG, which does not contain Ford either.

Nor is the ABX a similar animal to the benchmark equity indices. Unlike traditional indices which are built by summing up the price or total return on their constituents, the ABX – much like its siblings the Markit CDX, LCDX and CMBX – is composed of synthetic securities and is designed to be traded. Its constituents, by contrast, trade only thinly and have no officially published prices.

Pricing divergence

Similar to closed-end mutual funds where current prices can trade away from net asset values, the levels at which the ABX trades, and the prices that are quoted in newspapers, are not calculated values but market levels that reflect the risk appetite of participating investors. It is the difference in investor risk appetite between trading a synthetic index and trading the basket of underlying securities that creates the divergence between the indices and the underlying market. Since it is easier to short a derivatives index than it is to short a cash instrument, it is the index that will be most likely to reflect bearish sentiment.

The key to valuing any security lies in either the investor's ability to project and discount cashflows generated by the security or the investor's ability to assess the relative value of the underlying security against other securities in its market sector. So, while the ABX can provide broad value benchmarks with the limitations mentioned earlier, in order to value a portfolio of ABS securities, investors and auditors should use a broad range of inputs. We are now seeing a move towards the use of other parameters as key inputs to valuations and the Fed's recent comments on the interpretation of FAS 157 are leading this trend.

So what has the ABX done for the markets? It was created to provide institutional investors with a transparent, liquid trading tool to hedge and trade mortgage credit risk – and it has done just that. Launched at a time when the credit markets were buoyant, it has brought transparency to a relatively opaque market and allowed the more savvy investors to hedge risk that would otherwise have decimated their returns.

Once the financial markets fully diversify their valuation toolkit beyond this tradable index, and incorporate other inputs into their valuation processes, the index can once again return to being simply a standardised and liquid tool for gaining or hedging exposure to US subprime residential mortgages.

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